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PART I—TAX ASPECTS OF ESTATE AND TRUST PLANNING AND ADMINISTRATION

TAX PROBLEMS IN THE ADMINISTRATION OF AN ESTATE

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There are certain fundamental tax problems which will arise in the administration of every estate. The purpose of Part I is to consider those problems with which nearly every fiduciary will be faced. A great deal of what we have to say is elementary, but it is our desire to bring together those basic rules scattered through various parts of the Internal Revenue Code which deal with tax problems which arise because of the administration of an estate.

Naturally almost any type of tax question can be encountered during administration of an estate. If, for example, the estate is operating a business, the executor will encounter the same tax problems and must take into account the same tax considerations as any other individual operating a business. These are not our concern. We are concerned with those which the executor or administrator faces because he is administering an estate.

ESTIMATED TAX

One of the first tax problems which faces any executor is what should be done about further payments on the declaration of estimated tax filed by the decedent. That declaration may have been a separate declaration filed by the decedent alone or it may have been a joint declaration filed by the decedent and his spouse. In either event no further payments are required by the executor.¹ If, however, the declaration is a joint one, the attorney for the executor should advise the surviving spouse that, due to the fact that liability on the joint estimate

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¹Rev. Reg. § 1.6153-1(a)(4).

is joint and several,² the spouse is liable for the remaining payments unless an amended separate estimate is filed.³ Whether or not a separate amended estimate is called for will, of course, depend on the facts of the particular case. For example, if all of the income used as a basis of the joint estimate is that of the surviving husband, he will probably want to continue payments on the joint estimate without amendment. On the other hand, if the surviving spouse has relatively little or no income of her own, she will probably want to file an amended separate estimate so as to reduce or eliminate further payments.⁴

Filing of an amended separate estimate will not affect the right of the surviving spouse to join with the fiduciary in the filing of a joint return for the taxable year of death. Credit may be taken on that joint return both for payments made prior to death on the joint estimate and for payments made after death on the amended separate estimate.

FINAL RETURN

The next questions with which an executor is faced relate to the final income tax return of the decedent. When is the return due? What period is covered by the return? What items of income and deductions are to be included in that return?

In the case of the last return of a decedent, the rules requiring the filing of a return are the same as in the case of any individual taxpayer. A return must be filed if the decedent had gross income in excess of \$600 from the beginning of his taxable year up to the date of his death.⁵ If at the time of death he was sixty-five years of age or older, a return is not required unless the gross income exceeded \$1,200.

Death brings to an end the taxable year of the decedent. The final return covers, therefore, the income from the beginning of the taxable year up to and including the date of death. This final return is due at the time when the decedent's return would have been due if he had survived.⁶ That is, in the case of a calendar year taxpayer the return is due on April fifteenth of the year following the date of death. In the case of a decedent who had been filing on the basis of a fiscal year, the final return is due on the fifteenth day of the fourth month following the twelfth month after the beginning of the fiscal year.

Frequently the executor will be faced with the problem of filing two returns. Assume that a calendar year taxpayer dies on March thirty-

² INT. REV. CODE OF 1954, § 6013(d)(3).

³ Rev. Reg. § 1.6015(b)-1(c).

⁴ Actually in a situation where the wife has little or no income and the tax to the date of death has been substantially paid, the consequences of failure to amend the estimate are not serious. Under the 1954 Code there is no longer a separate penalty for failure to pay installments of estimated tax and the only penalty is for substantial underestimate. The penalty is six per cent interest for the period of underestimate. INT. REV. CODE OF 1954, § 6654.

⁵ INT. REV. CODE OF 1954, § 6012(a), (b).

⁶ INT. REV. CODE OF 1954, § 6072(a).

first before filing his return for the preceding calendar year. The executor will have to prepare not only the return for the short period but also the return for the full year prior to death. That full year return is due at the same time it would have been due had the decedent lived, namely on April fifteenth or only two weeks after death. This would mean that the executor must either file quickly or secure an extension of time.⁷ The return for the short period up to March thirty-first is not due for twelve and one-half months, *i.e.*, not until April fifteenth of the next year.

Before considering the items of income and deductions to be included in the final return, let us consider one other problem. Can the surviving spouse file a joint return with the decedent and preserve the tax benefits of income splitting? A joint return can be filed covering the decedent's income up to the date of death and the income of the surviving spouse for the full year. The right to file a joint return exists even if both husband and wife die during the taxable year. The filing of a joint return is optional the same as it is if both husband and wife are alive at the time of filing the return.⁸ The joint return can not be made if either spouse was at any time during the taxable year a nonresident alien. Similarly, a joint return can not be filed if the taxable year of either spouse is a short year because of a change of accounting period. A joint return likewise cannot be made if the surviving spouse remarries prior to the end of his or her taxable year.

The election to make a joint return is exercised by merely filing a joint return. No other formality is required. If an executor or administrator has been appointed prior to the time for filing the return, the election must be made by such personal representative. If no personal representative has been appointed prior to the time for filing the return of the surviving spouse, the surviving spouse may make the election both as to himself and as to the decedent. Such an election may, however, be disaffirmed by an administrator or executor who is subsequently appointed. The disaffirmance is made by filing a separate return for the decedent within one year after the last day for filing the return of the surviving spouse.⁹

If separate returns for the year of death or a prior year are filed, the executor and the surviving spouse may thereafter elect to file a joint return.¹⁰

The authority of the fiduciary to join in the filing of a joint income tax return with the surviving spouse is permissive and not mandatory. There are two distinct problems in connection with the exercise of

⁷ This can be done by filing a request for extension of time with the local district director.

⁸ INT. REV. CODE OF 1954, § 6013(a).

⁹ INT. REV. CODE OF 1954, § 6013(a)(3).

¹⁰ INT. REV. CODE OF 1954, § 6013(b).

the authority to file a joint return.¹¹ The first question is whether the executor or administrator is subjecting himself to possible surcharge for filing a joint return in the absence of specific authority in the decedent's will. The second question has to do with allocation of the tax if a joint return is filed.

There is some feeling that an executor should not under any circumstances consent to the filing of a joint return with the surviving spouse unless it is specifically authorized by the decedent's will. This view is based primarily on the fact that the liability for tax on a joint return is joint and several. Under these circumstances it is possible that the estate might be subjected to liability for additional taxes due in reality from the surviving spouse but where the government found it impracticable or undesirable to attempt to collect from the surviving spouse. There is also the question of possible liability for fraud penalties if the surviving spouse has fraudulently failed to report income on the joint return. The likelihood of serious liability to the estate or the executor or administrator would appear, however, to be somewhat remote in most circumstances. The problem is sufficiently grave, however, that at least three states have adopted laws under which, in the absence of specific authority in the decedent's will, the personal representative must secure court authority before joining in the filing of a joint income tax return with the surviving spouse, or before consenting to the splitting of gifts to third persons under the gift tax law.¹² Ohio has no such statutory provision.

The second question of how the tax on a joint return should be allocated as between the estate and the surviving spouse is probably of more real significance in most situations. The extent of this problem is, of course, one of degree. There is no problem in the situation where the deceased husband had all of the income and his surviving wife had no income. In this situation, the executor would probably be under a duty to join in a joint return thereby reducing tax liability of the estate and certainly he would be under an obligation to pay the entire tax shown on that return.

The problem of allocation arises only where both spouses have taxable income. Even though the husband had been in the habit of paying the full tax for both himself and his wife, it would not be desirable for the husband's executor to continue this practice unless the will gives him

¹¹ A provision similar to the filing of joint income tax returns is contained in the gift tax provisions of the law, Section 2513, under which a taxpayer and his spouse may consent to having gifts made by either to third persons treated as having been made one half by each. Under this provision, an executor or administrator may consent to a gift from the surviving spouse to a third party being treated as having been made one half by the decedent. Rev. Reg. § 25.2513-2. The same problems face the executor or administrator in making the election under both the gift tax and income tax.

¹² ARK. STAT. § 62-2412.1 (Supp. 1957); COLO. REV. STAT. ANN. § 152-10-19 (1953); ILL. ANN. STAT. c. 3, § 495(a) (Smith-Hurd Supp. 1958).

specific authority to do so. The payment of the wife's share of the joint tax would in effect constitute an additional distribution to the wife which the executor should not assume. Certainly the only sound course for an executor or administrator to follow in the absence of a specific provision of the will to the contrary would be to pay only a pro rata share of the tax shown on the joint return.

The question of what is a fair pro rata share of the joint tax may be a difficult one. There are two methods of apportionment which might be considered. The tax might be apportioned upon the basis of the relationship of the taxable income of the respective spouses, or the tax might be apportioned upon the basis of the relationship between the taxes which would have been paid by the respective spouses on separate returns. Either of these two methods would appear to be fair, but the regulations issued under the federal estate tax provide that, in the absence of evidence to the contrary, the decedent's share which may be claimed as a debt on the estate tax return will be presumed to be a proportionate share based upon the tax which would have been shown on separate returns.¹³

What items of income and what deductions are to be included on the last return of the decedent? To answer this question, the executor or administrator must first ascertain what method of accounting was used by the decedent in filing his returns. The last return is to include only those items of income which the decedent would have been required to report up to the date of his death on the basis of accounting regularly used by him. Similarly, only those deductions may be claimed which could have been claimed by the decedent up to the date of his death under the method of accounting used by him. Death does not result in the accrual of income or deductions.¹⁴

There is one exception to this general rule that death does not result in the accrual of income or expenses. This exception is provided by Section 213(d) of the code which deals with medical expenses. It provides that expenses for the medical care of the decedent which are paid out of his estate within the one-year period after his death are treated as having been paid at the time they were incurred. This means that in the case of a cash basis taxpayer, the medical expenses which are paid out of the estate within the one-year period after death may be claimed as a deduction on the decedent's last return.¹⁵

The amount of the deduction for these medical expenses is subject to the general limitations on medical expenses. For example, if neither

¹³ Rev. Reg. § 20.2053-6(f). A similar problem would exist as to apportionment of the gift tax liability where the executor or administrator has consented to gift splitting.

¹⁴ INT. REV. CODE OF 1954, § 451; Rev. Reg. § 1.451-1(b).

¹⁵ Of course, if the decedent was one of those rare individuals on an accrual basis, the expense would be accrued and deducted on the last return without regard to Section 213(d).

the taxpayer nor his spouse had reached the age of sixty-five, the medical expenses will be deductible only to the extent that they exceed three per cent of the gross income shown on the return. Similarly, the deduction will be subject to the maximum limitations provided by Section 213.

A rule prohibiting double deductions similar to that which is discussed *infra*¹⁶ applies in the case of medical expenses paid out of the estate after death. These expenses may not be claimed as a deduction both on the income tax return and on the federal estate tax return of the decedent. In order to take the deduction on the income tax return, a statement must be filed to the effect that the deduction has not been allowed on the estate tax return and waiving the right to have the amount claimed on the income tax return allowed as an estate tax deduction.¹⁷ It is not altogether clear whether medical expenses paid after death may be split and part taken as an income tax deduction and part as an estate tax deduction. This would be important where the amount paid after death resulted in the total medical expenses exceeding the maximum allowable as a deduction for income tax purposes. Logically, there is no reason why the split could not be made and a part of the deduction taken on the income tax return and the balance on the estate tax return.

We have stated the general rule that income does not accrue by reason of death and is to be reported on the last return of the decedent in accordance with the method of accounting regularly employed by him. Let us look now at how these rules would be applied to specific classes of income. Since most individual taxpayers file their tax returns on the cash basis of accounting, let us consider a few examples of income of a cash basis taxpayer which would or would not be included on his last return.

The most common situation is that of accrued but unpaid salary or wages. Only the wages or salary actually received by the decedent prior to his death would be included on his last return. Wages paid after his death would not be included.¹⁸ Dividends declared but unpaid on the date of death would not be included in the decedent's last return. Rent due but not yet received would not be included in the last return. On the other hand, interest coupons on a coupon bond which have matured but which the decedent had not yet cashed would be included since they should be included in the taxable period in which they mature, not in the period in which they are cashed.

¹⁶ Cox, *Executor's Election To Claim Certain Deductions for Income or Estate Tax Purposes*, 20 OHIO ST. L.J. 23 (1959).

¹⁷ INT. REV. CODE OF 1954, § 213(d)(2).

¹⁸ Withholding of income tax on wages paid after death is not required. Rev. Reg. § 31.3401. Nevertheless employers frequently do withhold. There are several ways of correcting this error but the simplest is to attach a Form W-2 (covering only the payments after death) to the Form 1041 and claim the tax withheld as a credit against the tax of the estate. Rev. Rul. 501, 1957-2 CUM. BULL. 849.

Special attention should be paid with respect to the taxability of income from a partnership. Under the provisions of the Internal Revenue Code death does not normally terminate the taxable year of a partnership.¹⁹ The law also provides that the income of a partnership is to be taxed to the partner in the taxable year of the partner during which the taxable year of the partnership ends.²⁰ This means that if both the decedent and the partnership of which he was a member were on the calendar year basis of accounting, the partnership income for the calendar year of death will not be included in the last return of the decedent. Rather it will be included in the taxable year of the estate or other successor in interest to the decedent's interest in the partnership within which the last day of the calendar year of death fell. To be specific, if a calendar year taxpayer who was a member of a calendar year partnership died in 1958, and death did not terminate the partnership, the decedent's share of partnership income for the full year 1958 would be reported in the taxable year of his estate which included December 31, 1958. No part of the partnership income, not even amounts withdrawn by the decedent, would be included in the decedent's last return.

The rule with respect to partnership income can lead to some unexpected results. This particular problem is also discussed *infra*.²¹ Unless the executor is careful in selecting the fiscal year for the estate or in properly timing the distributions from the estate to the beneficiaries, he may find that he has lost the benefits of income splitting in the year of death. For example, if substantially all of the decedent's income came from a partnership and none of that income is included in the last return, the benefits resulting from lower tax brackets on a joint return filed for the year of death may be lost. Similarly, with the bulk of the income (*i.e.*, the partnership income) eliminated from the last return, the executor may find himself in a situation where deductions go to waste. That is, the deductions and personal exemptions may exceed the small amount of income reportable on the last return.

In the case of a decedent who is survived by a wife, the solution to the problem is to arrange for all or a part of the partnership income to be taxed to the surviving wife. This will permit the income to be included as her income on the final joint return. Taxation of the partnership income to the surviving spouse can be accomplished in two ways. One of them is by proper selection of a fiscal year for the estate and by proper timing of distributions from the estate. As pointed out *infra*, this route may not be open if the decedent picked the wrong time to die.²² The other method is open only before death and depends upon proper drafting of the partnership agreement.

¹⁹ Rev. Reg. § 1.706-1(c)(3).

²⁰ INT. REV. CODE OF 1954, § 706(a).

²¹ Williams, *Picking A Fiscal Year, Timing and Nature of Distributions*, 20 OHIO ST. L.J. 16 (1959).

²² *Ibid.*

In the case of an unmarried taxpayer who dies while a member of a partnership, there is only one solution to the problem of excess deductions on the decedent's last return. This lies in proper drafting of the partnership agreement.

There are two ways in which the above problems can be treated in the partnership agreement. Normally, death does not terminate the partnership taxable year, but under the regulations it may be terminated as to the deceased partner if his interest is sold concurrently with his death.²³ If the partnership agreement is so drawn that death automatically results in a sale or exchange of the entire interest of the deceased partner, then the partnership year will terminate as to the deceased partner and his share of the partnership income will be included in his final return. This approach to the problem is available both as to the unmarried partner and the married partner. It may, however, be difficult to work out in a manner which is equitable to the deceased partner and at the same time is not too burdensome financially on the partnership. The reason for this difficulty is the fact that there is not a complete termination of the decedent's partnership interest until the interest is fully liquidated.²⁴ This prevents payment over a period of time.

The second approach to the basic problem of income splitting or excess deductions in the year of death is probably a more practical one. Provision can be made in the partnership agreement for designation of a successor to the decedent's interest in the partnership which is other than his estate. The partnership agreement might provide:

The decedent's interest in the income of the partnership shall be paid to his estate or to such other successor in interest as he shall have designated by written instrument filed with the partnership.²⁵

The partner might then designate his wife as successor to his interest in the partnership. If this were done, the wife as designated successor in interest would report in her return the decedent's share of the partnership income for the full partnership year.²⁶ This would enable her to include the partnership income in the final joint return and thus secure the benefits of income splitting.

It is not necessary to designate a single successor to the partnership interest. It might be broken into two or more parts as, for example, one half to the wife and one half to the estate. This might be even more advantageous in splitting a substantial income into several taxable entities.

Another possible solution to the handling of partnership income would be to allow it to be taxed to the estate but to provide for manda-

²³ Rev. Reg. § 1.706-1(c)(3)(vi) example 2.

²⁴ Rev. Reg. § 1.706-1(c)(3)(ii); Rev. Reg. § 1.736-1(a)(1)(ii).

²⁵ There is some question as to whether such an instrument would have to be executed with the formality of a will. The better view would seem to be that it would not since it is a contractual right with a third party similar to the designation of a beneficiary under a pension plan or insurance contract.

²⁶ Rev. Reg. § 1.706-1(c)(3)(iii).

tory distribution of income during the period of administration of the estate as suggested *infra*.²⁷

Another type of income which should be given special attention is interest on Series E and similar government bonds issued at a discount. The law permits a cash basis taxpayer to elect in any year to report this interest on an accrual basis.²⁸ If the election is made, all interest on all such bonds must be accrued up to the last day of the taxable year in which the election is made. If the year of death is one where the other income is lower than the probable income of the survivor who will receive the bonds, it may be desirable to make the election on the decedent's last return. A factor which may partially offset the benefit of the election and which should, therefore, be considered is possible loss of the deduction under Section 691(c) for estate tax attributable to income in respect of a decedent. This deduction is discussed below.

What happens to the items of income and deductions which have accrued prior to death but are not reportable on the decedent's last return because he was on a cash basis? Do they escape tax entirely? Unlike unrealized appreciation of capital assets,²⁹ these items of accrued but uncollected income do not escape tax. They are what is known as income in respect of a decedent and their tax treatment is specifically covered by Section 691.

Income in respect of a decedent is taxable to the ultimate recipient of that income in the year in which he receives it. The person taxable on such income may be the estate or a person who receives the right to the income either directly or by distribution from the estate.³⁰ In any event, the income will be taxed to the taxpayer who actually collects it.

For example, if salary earned prior to death is subsequently collected by the executor, it must be reported by the estate as taxable income in the year it is collected. Similarly, rent accrued prior to death but collected by the heir to whom the real estate passed must be reported by the heir in the year the rent is collected. If the election as to interest on government bonds issued at a discount has not been made, the interest must be reported by the person who cashes in the bonds and collects the interest which had accrued prior to death.

The tax character of income in respect of a decedent is determined by what its character would have been in the hands of the decedent.³¹ It will be capital gain or ordinary income to the recipient, depending upon whether it would have been capital gain or ordinary income if collected by the decedent. For example, if the decedent was a dealer in

²⁷ Polster, *Provisions of Wills Affecting Estate Administration and Their Tax Consequences*, 20 OHIO ST. L.J. 36 (1959).

²⁸ INT. REV. CODE OF 1954, § 454(a).

²⁹ Capital assets held at death secure a new basis equal to the fair market value at the date of death. INT. REV. CODE OF 1954, § 1014.

³⁰ INT. REV. CODE OF 1954, § 691(a).

³¹ INT. REV. CODE OF 1954, § 691(a)(3).

securities or in real estate and sold property prior to his death, the profit (which would have been ordinary income if he had collected the sale price) will be taxed as ordinary income to the estate which collects the proceeds, even though the estate is not in the securities or real estate business.

As noted above, income in respect of a decedent is normally taxable when the income is collected. There is an exception to this rule in the case of a transfer of the right to receive income.³² The exception does not apply in the case of a transfer to a beneficiary upon a distribution from the estate. In all other cases, the income must be reported in the year in which the income right is transferred. This applies to the case of a gift of the income right as well as to a sale.

In other words, the estate or the person who received the income right from the decedent cannot escape taxation by transferring the income right. If the right is sold, then income is realized at the time of sale, and the nature of the income is the same as it would have been if it had been collected by the decedent. Similarly, a transfer by gift results in realization to the donor of the income in respect of a decedent. Thus, a high bracket taxpayer cannot transfer an item of income to his low bracket child, for example, by a gift.

The rules with respect to income in respect of a decedent apply to installment obligations owned by the decedent at the time of his death. Assume, for example, that the decedent had sold real estate and elected to report the profit on the installment basis, as deferred payments on the purchase price were collected. As these installment obligations are collected (or transferred), the profit portion of each installment will be taxed as income to the recipient in the same manner in which it would have been taxed to the decedent.

The rules relating to income in respect of a decedent are not all one-sided. They also apply to certain deductions and credits.³³ Business expenses, non-business expenses, interest, taxes and depletion which accrued prior to death but which were not deductible in the decedent's last return under his method of accounting, may be deducted by the estate or beneficiary when paid. The same is true of the foreign tax credit. The deduction for depletion is to be taken by the person who receives the income to which the depletion relates. The other categories of deductions mentioned above are to be taken by the estate unless the estate is not liable to discharge the obligation to which the deduction relates. In such a case, the deduction is to be taken by the person who receives the property subject to the obligation. For example, unpaid real estate taxes which are a lien against the property at the time of death are to be taken as a deduction by the devisee of the real estate when the taxes are paid.

³² INT. REV. CODE OF 1954, § 691(a)(2).

³³ INT. REV. CODE OF 1954, § 691(b).

The prohibition against double deductions (income tax and estate tax) which is discussed *infra*³⁴ does not apply to deductions covered by Section 691(b). For example, the real estate taxes mentioned above could be claimed both as a deduction for estate tax purposes as a lien against the real estate and also as a deduction for income tax purposes. Similarly, accrued but unpaid business expenses can be claimed as deductions under both the estate tax and income tax.

Because items of income in respect of a decedent may be taxed twice (*i.e.*, as an asset of the estate for estate tax purposes and as income for income tax purposes), it is possible for the two taxes to aggregate more than 100 per cent of the amount in question. To offset this inequity, a special deduction is given.³⁵ The deduction is permitted on the income tax return and is taken in the same year in which the income is reported. The amount of the deduction allowed is equal to the estate tax attributable to the item of income which is included in gross income.

The method of calculating the Section 691(c) deduction is somewhat complicated. The only way to fully understand the calculation is to work one through. The first step is to determine the net amount of all of the items of income and deductions in respect of a decedent which are included on the federal estate tax return. The estate tax is then recalculated on the basis of excluding the net amount of the Section 691 income and deductions from the gross estate. The difference between the actual federal estate tax and the amount thus computed is the total of the deduction to be allowed under Section 691(c) to all recipients of income in respect of a decedent for all years in which such income is received. The total deduction is then prorated among taxpayers and tax years in the ratio which the income in respect of a decedent included on the particular return bears to the total income in respect of a decedent, ignoring for this purpose any deductions covered by Section 691(b).

In the case of an estate or trust which receives income in respect of a decedent and which makes distributions to its beneficiaries, each beneficiary is entitled to a share of the special deduction for estate tax attributable to income in respect of a decedent. The Commissioner has ruled that the deduction passes on through the estate to the persons ultimately having beneficial enjoyment of the income. For purposes of allocating the Section 691(c) deduction, items of income in respect of decedent which are distributed by the estate are treated as having been received directly by the beneficiaries.

A special rule applies in the case of survivor annuitants under a joint and survivorship annuity. Since the annuity exclusion under Section 72 continues to the survivor, it is only the excess over the exclusion which is subject to both the estate tax and income tax. The value of this excess is based upon the survivor's life expectancy. Therefore the special

³⁴ Cox, *supra* note 16.

³⁵ INT. REV. CODE OF 1954, § 691(c).

Section 691(c) deduction is related to the excess which is included in income during the survivor's life expectancy.

Even though not accrued prior to death, amounts paid in liquidation of a partnership interest which are taxable as income under Section 736 are treated as income in respect of a decedent.³⁶ Such partnership income must be included in the calculation and allocation of the special deduction. The recipient of distributions from a partnership which are taxable as income is entitled to his share of the special Section 691(c) deduction.

A rule similar to that contained in Section 691(c) is found in Section 421(d)(6)(B) dealing with restricted stock options. If the value of a restricted stock option is included in the gross estate, the estate is entitled to an income tax deduction for the estate tax attributable to the inclusion of the value of the option in the gross estate.

The deductions under Sections 691(c) and 421(d)(6)(B) are frequently overlooked. The federal estate tax return is not due until fifteen months after death. Because of the option given to value assets as of the anniversary of death,³⁷ the return is usually not filed until at least twelve months after death. Under these circumstances, it often is not possible to compute the amount of the special deduction at the time the income tax return which includes the item of income is filed. Thus, it is necessary either to estimate the deduction or to wait and file a claim for refund. Neither alternative is particularly satisfactory. This is particularly true in situations where the only item of Section 691 income is a small amount of accrued dividends. Often it is better to ignore the small deduction rather than reopen an otherwise complicated return by the filing of a refund claim.

In the case of accrued interest on government bonds which may not be cashed for several years by the surviving joint owner, the special deduction is forgotten more frequently than not.

Even where it is possible to compute the special deduction at the time of filing the income tax return, the deduction may be subject to change upon audit of the federal estate tax return. This will often occur two or three years after the estate tax return was filed. It may even occur after the period of limitations has expired on the income tax return in which the deduction was claimed.³⁸ If the amount is significant, appropriate steps should be taken to keep the income year open so that the increased deduction can be claimed. On the other hand, if the amount is not significant a beneficiary, for example, may not want to subject his entire return to audit by filing a claim for refund when the amount of the special deduction is finally determined.

Thus far we have covered primarily income arising prior to death

³⁶ INT. REV. CODE OF 1954, § 753.

³⁷ INT. REV. CODE OF 1954, § 2032.

³⁸ This is not one of the circumstances covered in Section 1312 relating to mitigation of the period of limitations.

whether it is reportable on the decedent's last return or on a subsequent return as income in respect of a decedent. We turn now briefly to income which arises subsequent to death during the period of administration of the estate.

An estate is a taxable entity.³⁹ It is entitled to a personal exemption of \$600.⁴⁰ In general the income and deductions are computed in the same manner as for an individual⁴¹ except that an estate cannot claim a standard deduction,⁴² and the estate is granted an unlimited charitable deduction for amounts which, pursuant to the governing instrument, are paid or permanently set aside for charitable purposes.⁴³

The major differences between the taxation of an estate and of an individual lie in the fact that the estate is entitled to a deduction for (1) *amounts of income* for its taxable year which are required to be distributed and (2) *any other amounts* properly paid or credited or required to be distributed for such taxable year.⁴⁴ The amount of deduction cannot exceed the distributable income for the current year. The amounts which are deductible by the estate under this provision are taxed to the beneficiaries.⁴⁵

The above provisions as to deduction by an estate or trust of distributions is what is known as the "two tier rule."⁴⁶ Amounts of income required to be distributed are in the "first tier" and are deductible whether or not they are actually distributed. Under the concept adopted in the 1954 Code, the current income is first reduced by amounts in the first tier. Any other distributions properly made during the years are then deducted to the extent of the balance of the current year's income. These are so-called "second tier" distributions. It is to be noted that second tier distributions do not have to be distributions of income in the probate sense and what may be considered as a residuary distribution of principal from the probate standpoint may be a second tier distribution of income for tax purposes. This can cause considerable tax difficulty if the executor is not fully aware of what he is doing.

Gifts or bequests of specific property and gifts or bequests of a specific sum of money which is paid all at once or in not more than three installments are not considered a second tier distribution of income.⁴⁷ If, however, the amount can only be paid from income it is a second tier distribution.

The year's allowance paid to a widow under Ohio law is not

³⁹ INT. REV. CODE OF 1954, § 641.

⁴⁰ INT. REV. CODE OF 1954, § 642(b).

⁴¹ INT. REV. CODE OF 1954, § 641(b).

⁴² INT. REV. CODE OF 1954, § 142(b)(4).

⁴³ INT. REV. CODE OF 1954, § 642(c).

⁴⁴ INT. REV. CODE OF 1954, § 661(a).

⁴⁵ INT. REV. CODE OF 1954, § 662(a).

⁴⁶ Polster, *supra* note 27, at 48.

⁴⁷ INT. REV. CODE OF 1954, § 663(a)(1).

treated as a distribution which is taxable to the widow as income. The regulations issued by the Commissioner specifically provide that an allowance such as the widow's allowance is not treated as a distribution of income in either the first or second tier unless under local law it is payable out of or chargeable to income.⁴⁸ Since under Ohio law the year's allowance to the widow is chargeable to principal, it is not taxed to the widow as a distribution of income.

Similarly in the case of an Ohio estate, real estate will not be considered as a distribution taxable as income to the heir or devisee, since under Ohio law it passes directly from the decedent to the heir or devisee, and under the regulations it is not, therefore, to be considered income which is required to be distributed or an amount which is paid or credited to a beneficiary.⁴⁹

Second tier distributions deductible by the estate and taxable to the beneficiaries as income may, however, include property distributed in kind.⁵⁰ This is true only if the property is not specifically bequeathed and is distributed in satisfaction of a residuary bequest since specific bequests come under the exception noted above which is provided in Section 663(a). In the case of a distribution in kind which is treated as a second tier distribution, the amount deductible and the amount to be included in income by the beneficiary is the fair market value at the time of distribution.⁵¹

Amounts which are deductible by the estate as amounts of income required to be distributed (first tier) and other amounts properly paid or credited to a beneficiary during the taxable year (second tier) are required to be included in income by the beneficiary. Unless the will specifically provides otherwise, each beneficiary will be considered as having received his proportionate share of each class of income received by the estate.⁵² If the estate has income from dividends, taxable interest, and tax-free interest, for example, each beneficiary to whom distribution is made will report a share of the dividends and the taxable interest and will be considered as having received a share of the tax-exempt interest unless the will specifically provides otherwise. In the absence of specific authority, the tax free interest cannot be treated as having been distributed to one beneficiary (who might, for example, be in a high tax bracket) and the taxable income to the others (who might be in lower tax brackets).

Income which is required to be distributed is to be reported by the beneficiary during his taxable year with or within which the taxable year of the estate ends.⁵³ If both the estate and the beneficiary report on the

⁴⁸ Rev. Reg. § 1.661(a)-2(e).

⁴⁹ Rev. Reg. § 1.661(a)-2(e).

⁵⁰ Rev. Reg. § 1.661(a)-2(c).

⁵¹ Rev. Reg. § 1.661(a)-2(f).

⁵² INT. REV. CODE OF 1954, § 661(b).

⁵³ INT. REV. CODE OF 1954, § 662(c).

calendar year basis, income distributable to the beneficiary will be taxed to him in the year it is received by the estate, even though not actually distributed. On the other hand, if the beneficiary reports on a calendar year and the estate uses a fiscal year ending January thirty-first, the beneficiary will not report income received by the estate during its fiscal year ended January 31, 1959, for example, until his return for the calendar year 1959. This is true, even though the income is actually received by the estate and in turn distributed to the beneficiary during 1958.

Income which is not required to be distributed is deductible by the estate and taxable to the beneficiary only if it is actually distributed within the taxable year of the estate. It is taxable to the beneficiary in his taxable year during which the taxable year of the estate ends. Thus, if a beneficiary used the calendar year and the estate used a fiscal year ending January thirty-first, income actually distributed in July of 1958, for example, would not be reported by the beneficiary until 1959.

In the case of an estate, income in excess of the current income of the estate which is distributed to a beneficiary is not taxed to the beneficiary.⁵⁴ Once the estate has paid tax on income, it may be distributed in a later year to beneficiaries free of tax. This is true, however, only where there is an excess distribution during a particular year since all distributions are considered to be distributions of income for the current year to the extent of the income for the current year. From the foregoing it is apparent that the timing and extent of distributions may determine the rate at which the income is taxed. This subject is treated *infra*.⁵⁵

This article has summarized briefly the problems which will be faced by an executor or administrator and the general rules by which he should be guided in preparing the final return of the decedent and in preparing and filing his own fiduciary income tax return. It has been possible to state only the general rules and to note some areas in which caution must be exercised. Some of the specific problems will be treated in more detail *infra*.

⁵⁴ See Sections 665-68 for the treatment of certain excess distributions from trusts.

⁵⁵ Williams, *supra* note 21.